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Via Federal Express and Hand Delivery

Director
Tobacco Division
Farm Service Agency
United States Department of Agriculture
STOP 0514, Room 4080-S
1400 Independence Avenue, SW
Washington, DC 20250-0514

Re: Comments on the Fair and Equitable Tobacco Reform Act of 2004, 67 Fed. Reg. 67,298 (November 17, 2004)

Dear Director:

We are small tobacco companies, including family-owned businesses, that manufacture and import cigarette products. We are soon to become subject to substantial monetary assessments levied by the United States Department of Agriculture ("USDA") under the "Fair and Equitable Tobacco Reform Act" (the "Act"), which was signed into law on October 22, 2004 as Title VI of the "American Jobs Creation Act of 2004." As you know, the Act repeals all aspects of the Federal tobacco support program and provides payments to eligible quota holders and tobacco producers from funds collected from tobacco manufacturers and importers.

We write in response to the USDA's notice of meeting and request for comments regarding the implementation of the assessment provisions of the Act, published in the *Federal Register* on November 17, 2004. 69 Fed. Reg. 67298. We find it extremely difficult to provide meaningful comments to USDA at this time. The Act contains broad and ambiguous provisions and, as discussed below, raises as many questions as it answers. For instance, the Act requires the USDA to make market share calculations which are fraught with difficulty; in fact, there have been ongoing disputes over data and measurement of aggregate and individual company market share by parties involved with the implementation and enforcement of the Master Settlement Agreement ("MSA") by state attorneys general since it went into effect in 1999.

Basic questions pertaining to the effective date of the Act and the effective dates for assessments and payments are not apparent on the face of the Act or from the limited legislative history and are the subject of considerable confusion and differing interpretations.

Indeed, certain of these issues have been raised and are being litigated in the context of a proceeding in the North Carolina Business Court, which is assessing the impact of the Act on the 2004 Phase II tobacco settlement payments (Case No. 98CVS14377). The Court has directed that the parties involved set forth their interpretation of the applicable effective dates of the Act and assessments and payments under the Act and how those dates will affect payment requirements under the Phase II Agreement, confirming the fact the Act does raise considerable doubt with respect to these issues. In a November 16, 2004 hearing, the presiding judge stated that he had written to the conference committee prior to enactment of the Act requesting that Congress clarify the various timing issues but that no clarification had been received.

The USDA has not yet promulgated any rules or guidance as to how it intends to implement these provisions. Our comments are therefore necessarily limited to general issues arising from the “four corners” of the Act, rather than to USDA’s interpretation of the Act. Moreover, companies had limited notice to prepare to speak publicly at the November 22, 2004 public meeting and to prepare these written comments. The limited time frame within which to prepare to speak publicly and to submit written comments has severely limited the ability of small companies to comprehensively review and identify concerns regarding the implementation of the Act and thus to provide meaningful comment. Therefore, as an initial matter, we **strongly urge** the USDA to allow comment on its plan to implement the assessment provisions, once issued, before it is finalized.

Notwithstanding this request to provide additional comment, we do wish at this time to express our concerns regarding the disproportionate economic impact on our businesses that could result from these assessments, and how we believe the Act can be implemented in a way that lessens this impact. We also write to further describe the large amount of uncertainty that has been created by the Act’s provisions as how the USDA chooses to resolve this uncertainty in implementing the Act will have significant impact on our businesses and on the tobacco industry as a whole. We therefore propose ways that the Act can be implemented by USDA or modified through a technical amendment so that the Act is more equitable to all members of the tobacco industry, thereby preserving jobs and maintaining the economic viability of small businesses.

I. BACKGROUND

Section 625 of the Act establishes the process for imposing assessments on tobacco product manufacturers and importers that will be used to fund payments to tobacco growers and quota holders. Section 625 directs the USDA to impose annual assessments on manufacturers and importers of tobacco products beginning during fiscal year 2005. Unless modified by the USDA, cigarette manufacturers and importers will be responsible for paying 96.331% of the total assessment.

The relative contribution of each manufacturer and importer of cigarettes is to be determined by “market share.” Section 625 defines “market share” as each manufacturer’s or importer’s share (expressed as a decimal to the fourth place) of the total “volume of domestic sales” of the class of tobacco product during the “base period” for a fiscal year for an assessment. The “base period” is the one-year period ending the June 30 before the beginning of the fiscal

year. The base period for the fiscal year 2005 assessments therefore encompasses July 1, 2003 through June 30, 2004.

Section 625 requires the USDA to calculate the relevant “volume of domestic sales” for each manufacturer or importer during the base year based upon information submitted by manufacturers and importers. Specifically, manufacturers and importers are required to submit certified copies of the returns or forms that relate to the removal of tobacco products into domestic commerce and the manufacturer or importer’s taxes imposed under chapter 52 of the Internal Revenue Code of 1986. The USDA will use these documents to determine the volume of sales for the manufacturer or importer. For cigarette manufacturers, “volume of domestic sales” is measured by the numbers of cigarettes.. After collecting this information, the USDA is directed to multiply the manufacturer’s or importer’s market share by the total amount of the assessment for that quarterly payment period for that tobacco product class. The USDA is directed to collect the assessments at the end of a calendar year quarter.

Further, the USDA is required to provide each manufacturer or importer subject to an assessment with written notice at least 30 days before the date the payment is due. These notices must provide extensive, company and industry specific information to affected manufacturers and importers, including: (1) the total assessment imposed on all manufacturers and importers of tobacco products; (2) the total assessment for the individual manufacturer’s or importer’s class of tobacco products; (3) any adjustments the Secretary made to the percentages of the assessment allocated to each tobacco product class; (4) the manufacturer’s or importer’s volume of gross sales used to determine market share for the applicable class of tobacco product; (5) the total volume of gross sales of the applicable class of tobacco products; and (6) the manufacturer’s or importer’s market share of the applicable class of tobacco product; and (7) the market share of each other manufacturer or importer for the applicable class of tobacco products.

II THE ACT RAISES SIGNIFICANT UNCERTAINTY AND PROVIDES INSUFFICIENT TIME TO DEVELOP, PROVIDE NOTICE OF AND PREPARE FOR ASSESSMENTS

The Act’s provisions are unclear and have created substantial confusion regarding how and when the assessments will be imposed. As currently structured, the assessment scheme apparently disregards certain market realities and requires the USDA to take measures that are nearly impossible, under any practical scenario, to accomplish in the manner and time periods set forth by Congress. Moreover, it provides insufficient time for companies to plan for and be able to pay the assessments.

➤ *Insufficient Time for Companies to Raise Funds to Pay Assessments.* The timing of the initial assessments during fiscal year 2005 provides the tobacco industry with little or no time to budget and account for the cash flows that will be needed to make the required payments. In addition, the use of market-share data from a historical “base period” means that manufacturers and importers will be assessed on the basis of sales of tobacco products that occurred at a time that may not bear a relation to their sales at the time the assessments are levied. Both the timing of the assessments and the use of historical rather than current data to

calculate market shares could have a devastating impact on members of the tobacco industry, particularly small businesses.

The USDA, at a minimum, in order to allow small businesses to budget and account for the cash flows needed to make the required payments, **should not levy** the initial assessment for any fiscal or calendar quarter until the quarter beginning January 1, 2005. Additionally, the amount of the quarterly assessments, including the initial quarterly assessment, should be in substantially equal amounts and thus the initial assessment **should not include** any “doubling up” for any fiscal or calendar quarter prior to January 1, 2005. This not only will allow the tobacco industry, particularly small businesses, to budget and adjust their cash flows in order to provide for the payment of assessments but will also help to ensure that the 2004 Phase II payments to farmers are preserved.

➤ ***Time to Develop and Provide Notice of Assessments.*** It is unclear how the USDA will be able to accurately issue the first notice of assessments while including all the company-specific information required by the Act. As experience under the MSA has demonstrated, market share computations in the tobacco industry are notoriously difficult to calculate. It takes the independent auditor under the MSA approximately three (3) months to calculate market share for MSA purposes after years of refinement of the process, with the independent auditor’s findings often being subject to dispute. How long will it take the USDA to assemble information to produce reliable estimates of each company’s market share in several categories of tobacco products? How will the USDA identify which companies are subject to the assessments? How will this information be provided to the companies prior to paying an assessment in order to assess the accuracy of the assessments and to self-police the industry – e.g., by ensuring that all manufacturers and importers subject to the Act are actually made subject to assessments. Unless sufficient time is taken to obtain reliable information and provide sound mechanisms for the levying and challenging of assessments, the result may well be a multitude of challenges by affected members of the industry.

There are a myriad of other issues raised by the assessment scheme that will require clarification for effective implementation. For example, in determining market shares, will the USDA consider “market returns,” e.g., cigarettes returned from retail establishments that remain unsold? Does “volume of domestic sales” include sales to Puerto Rico? How will the USDA account for defunct entities and new market entrants in calculating appropriate market shares? Further, given the difficulty in calculating market shares in this industry, how will companies be able to identify inappropriate assessments and file a challenge within the thirty-day timeframe prescribed in the Act? These are just a few of the Act’s other unanswered questions.

III. THE ASSESSMENT STRUCTURE ESTABLISHED BY THE “FAIR AND EQUITABLE TOBACCO REFORM ACT OF 2004” IS FUNDAMENTALLY UNFAIR TO SMALL BUSINESSES

If unchanged, the methodology imposed by Section 625 of this “Fair and Equitable” Act will result in an unfair and inequitable assessment on small cigarette manufacturers and importers, particularly those, like us, who are Subsequent Participating Manufacturers (“SPMs”). SPMs are small manufacturers and importers that have voluntarily signed on to the Master Settlement Agreement (“MSA”) subsequent to the original signatories.

The original signatories, who are referred to as the Original Participating Manufacturers (“OPMs”), are comprised of the largest cigarette companies. As voluntary signatories to the MSA, SPMs make substantial payments to the states and are subject to the MSA’s marketing restrictions.

The Act would disproportionately affect the SPMs for several reasons:

➤ ***The Act Will Relieve OPMs, But Not SPMs, of Other Financial Obligations.*** On July 19, 1999, the OPMs and 14 tobacco-producing states entered into the National Tobacco Grower Settlement Trust agreement, commonly referred to as the “Phase II Agreement.” Under the Phase II Agreement, OPMs agreed to pay a total of \$5.15 billion until 2010 to compensate tobacco growers and quota owners for the economic consequences resulting from the MSA. The Phase II Agreement contains a tax offset provision which relieves the OPMs of payment obligations if they incur a governmental obligation that flows to the benefit of tobacco growers or quota owners. The Act will trigger this offset provision in calendar years 2005 and beyond and may trigger this offset provision for calendar year 2004 dependent upon the decision of the North Carolina Business Court which is currently assessing the impact of the Act on the 2004 Phase II tobacco settlement payments. Thus, the Act will relieve OPMs of their significant payment obligations under the Phase II Agreement for calendar years 2005 and beyond and may relieve the OPMS of these payment obligations for calendar year 2004. In addition, the Act enables the OPMs to fund their assessments under the Act from the cash flows that had previously been reserved for their Phase II payments. Unlike the OPMs, the Act results in no financial relief to the SPMs and requires them to raise funds that were previously not set aside or otherwise anticipated.

➤ ***SPMs Will Be Subject to the Highest Per-Pack Costs of Compliance Under the Act Which Will Likely Result In Loss of Market Share to Big Tobacco Companies.*** When factoring in the incidental economic impacts of the Act that will be created by Phase II savings, the per-pack costs to small businesses paying the assessments envisioned by Section 625 will be substantially out-of-line with the per-pack costs to larger (and better positioned) cigarette companies. Unlike the OPMs, the SPMs do not have Phase II savings and most SPMs do not have the margins or premium brand names to afford or otherwise pass along the additional costs to consumers without losing market share. Thus, SPMs per-pack costs will increase significantly (approximately 5 times) relative to the per-pack costs of the big tobacco companies. Such disproportionate impact would likely result in loss of market share of small tobacco companies to the big tobacco companies.

➤ ***SPMs May Lose Market Share to MSA Non-Compliant Companies.*** SPMs would also likely lose market share to the companies with whom they directly compete at the lower price level – those companies who are either non-signatories to or are non-compliant with the MSA. Indeed, these non-signatories, or NPMs, are routinely not accounted for in calculations of industry market shares under the MSA, and, based on this precedent, it is likely that small SPMs will pay more than their actual share of assessments under this Act. Thus, as currently structured, the assessments required by Section 625 will result in a perverse reality where small cigarette companies who are compliant with the MSA will be disproportionately impacted not only in relation to large, well-established cigarette companies (in terms of per-pack

costs), but in relation to small, non-compliant cigarette companies. Congress has long recognized that small businesses are the lifeblood of the American economy. Under the Act, however, this federal policy has been stood on its head – small companies who are compliant with the MSA, and who already bear the financial burden and adhere to marketing restrictions, stand to suffer the most.

Simply put, requiring millions in new payments without taking into account and adjusting for inequities would negatively impact many, if not all, compliant SPMs and could provide big tobacco companies an opportunity to monopolize the cigarette market and dictate prices.

IV. THE USDA SHOULD ENSURE THAT ASSESSMENTS ARE LEVIED IN AN EFFICIENT AND EQUITABLE MANNER THAT DOES NOT DISPROPORTIONATELY BURDEN SMALL BUSINESSES

The foregoing highlights only some of the examples of the inequities inherent in the current method of assessment under the Act and the significant challenges facing the USDA to implement the Act in a fair, equitable and timely manner. As more fully described below, to address these issues and minimize potential confusion and challenges, we recommend that USDA take the following actions:

➤ ***Ensure Equitable Assessments That Reflect Market Realities.*** The USDA should request that Congress enact technical amendments to provide greater clarity and fairness to the assessment mechanisms, or to otherwise provide USDA with the discretion to modify the assessments as needed to implement the Act fairly and equitably. Specifically, the Act should be modified to result in a per-pack net cost to small cigarette manufacturers that is, after the elimination of Phase II payments, equal to the net per-pack cost to large cigarette manufacturers. This is critical to ensure a level playing field and to prevent further monopolization by the big tobacco companies. Thus modifying the assessments will have a significant impact on maintaining the economic viability of small businesses, but will have a relatively small impact on the big tobacco companies, nor would it jeopardize the overall buyout program. Congress can amend the Act in one of several ways:


- Reducing the assessments imposed on small cigarette manufacturers by a ratio comparable to the offsets available to the large cigarette manufacturers from the nullification of the Phase II payments, and/or vesting discretion in the Secretary to raise the assessments on the large cigarette manufacturers to recapture the amounts of such offsets.
- Clarifying that an assessment, at a minimum, is not to be levied for any fiscal or calendar quarter prior to the fiscal and calendar quarter beginning January 1, 2005 to ensure that the 2004 Phase II payments to farmers are preserved and to allow the USDA additional time to gain accurate information required for the implementation of the Act should USDA be of the opinion that it does not have the discretion to accomplish this under the Act as currently written.


- Vesting discretion in the Secretary to reduce the market shares of small businesses when deemed necessary to result in equitable assessments, and to reapportion the remaining market shares pro rata among the other members of the tobacco product class; or


➤ ***Delay The Promulgation Of Regulations, And Then Do So Through Notice-and-Comment Rulemaking.*** The USDA should forestall the issuance of assessments until such time as they can be issued in an equitable and transparent manner, and in compliance with the Act. In addition, due to the dramatic impacts that will follow from the USDA's resolution of these questions in rulemaking, we ask that affected members of industry be given an opportunity to comment.

We hope these comments are useful to the USDA as it promulgates regulations implementing the assessment provisions of the Act. We believe that industry involvement will be a crucial element in determining the most equitable and efficient mechanisms for implementing the Act. Therefore, we request the opportunity to meet with you directly regarding our unique perspective on these issues, or the opportunity to comment further once the USDA proposes regulations.

Should you desire additional information or wish to meet with representatives of our companies please contact Quinten Marquette, Commonwealth Brands, Inc., 700 Church Street, Bowling Green, Kentucky 42101, telephone number (270) 780-2884.


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